Calendar No. 876

99TH CONGRESS *2d Session*	SENATE	REPORT 99-426

THE GOVERNMENT SECURITIES ACT OF 1986

REPORT

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

TO ACCOMPANY

S. 1416

SEPTEMBER 3, 1986.—Ordered to be printed
Filed, under authority of the order of the Senate of August 16 (legislative day, August 11), 1986

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Mr. D'AMATO, from the Committee on Banking, Housing, and Urban Affairs, submitted the following

REPORT

[To accompany S. 1416]

LEGISLATIVE HISTORY OF THE BILL

The recent failures of several government securities dealers led to an evaluation of the adequacy of the current regulation of the market in government securities. The examination of the current regulatory scheme revealed specific weaknesses in the regulation of that market. Two bills were introduced to address the specific weaknesses in the existing regulatory framework.

On April 17, 1985, S. 936 was introduced by Senators Cranston, Proxmire and Riegle and on July 10, 1985, S. 1416 was introduced by Senators D'Amato, Cranston, Heinz and Proxmire. Subsequent cosponsors of S. 1416 include Senators Mattingly and Sarbanes.[1] Although the bills differed in certain aspects, they both focused upon the regulation of unregistered government securities brokers and dealers. These brokers and dealers previously had not been required to register with the Securities and Exchange Commission [Commission] because they traded in only government securities, which are defined as "exempted securites" under section 3(a)(12) of the Securities Exchange Act of 1934 [Exchange Act].

The Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs [Securities Subcommittee] conducted two hearings that addressed the adequacy of the current regulation

[1] All references to S. 1416 contained in this Report hereinafter are to S. 1416 as reported by the Senate Committee on Banking, Housing and Urban Affairs.

of the government securities market. The first hearing, held on April 19, 1985, addressed the regulation of the government securities market in the context of legislation pertaining to the reauthorization of appropriations for the Commission. The members of the Securities Subcommittee questioned Commission Chairman John S.R. Shad about the failures of two government securities dealers and the inadequate regulation of unregistered government securities brokers and dealers. On May 9, 1985, the Securities Subcommittee conducted a hearing that specifically addressed the existing deficiencies in the regulation of the government securities market. Testimony at this hearing was received from: Paula Hawkins, U.S. Senator from the State of Florida; Bill McCollum, U.S. Representative in Congress from the State of Florida; E. Gerald Corrigan, President of the Federal Reserve Bank of New York; and Richard M. Kelly, Chairman, Government and Federal Agency Securities Division of the Public Securities Association.

The Committee on Banking, Housing and Urban Affairs [Committee] met in open session on August 13, 1986, to consider a Committee print substitute for S. 1416. The Committee unanimously adopted the Committee print and then ordered the bill, S. 1416, favorably reported without objection.

Explanation of the Provisions of S. 1416

THE MARKET IN GOVERNMENT SECURITIES

The government securities market is the cornerstone of the U.S. capital market system. It serves as a means through which the Department of the Treasury [Treasury] finances the national debt and provides the ability for the Government to meet seasonal shortfalls between its receipts and expenditures.

The market in government securities consists of several broad categories of participants including the U.S. Government as the issuer of the securities through its fiscal agents, the 12 Federal Reserve Banks. In addition to the Treasury, issuer participants also include Government-sponsored corporations and Government agencies issuers of securities guaranteed by those entities.[2]

To sell marketable Treasury debt, the Treasury, through the 12 Federal Reserve district banks and their branches, sells securities to the public through a competitive auction process. In addition, the Federal Reserve Bank of New York, acting on behalf of the Federal Open Market Committee, uses the day-to-day purchases and sales of government securities as the primary instrument for the conduct of monetary policy.

Private participants in the government securities market include the so-called primary dealers in Treasury securities. The Federal Reserve Bank of New York has recognized a group of securities dealers and commercial banks as primary dealers. These are dealers with whom the Federal Reserve Bank of New York has a busi-

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[2] In addition to Treasury securities, the term "government securities" generally includes securities issued or guaranteed by government agencies, such as the Government National Mortgage Association [GNMA], or government-sponsored corporations, such as the Federal Home Loan Mortgage Corporation [FHLMC], the Federal National Mortgage Association [FNMA], and the Student Loan Marketing Association [SLMA].

ness relationship. They are required to demonstrate market-making capacity, creditworthiness and other factors that indicate fitness for this business relationship.

Ten years ago there were 25 primary dealers. This number has grown to the present level of 35. Fourteen of the primary dealers are banks or bank subsidiaries, 12 are broker-dealers subject to Commission regulation and 9 are otherwise "unregulated" at the Federal level. The primary dealers are the core group of purchasers for Treasury securities in that they participate directly and actively in auctions of new Government debt. They are also active in making markets in the over-the-counter secondary markets for Treasury and Federal agency securities. As market makers, primary dealers stand ready to buy and sell securities at the quoted bid and offered prices. They serve as the essential bridge between the Treasury and the vast domestic and international network of institutions and individuals who are the ultimate holders of Government debt.[3]

In addition to the primary dealers, there are a large number of non-primary or secondary dealers in government securities. The secondary dealers market new issues of government securities and act as market makers in government securities. There is considerable variation in the regulatory status of secondary dealers. Some are commercial banks, some are institutions regulated by the Com-

[3] As demonstrated by the figures below, the ownership of U.S. Treasury securities has been changing over the last 15 years. The primary change in the ownership of federal debt has been a shift of approximately 29 percentage points from federal government and individual accounts to foreign, state, local government and miscellaneous accounts which include savings and loans, credit unions and corporate pension trust funds.

ESTIMATED PERCENTAGE OWNERSHIP OF PUBLIC DEBT SECURITIES 1970 THROUGH 1985

End of fiscal year	Total [1]	U.S. Government accounts	Federal Reserve	Foreign and international	Private financial institutions [2]	Corporations	Individuals	State and local governments	Other [3]
1970	100.0	25.7	15.6	4.0	16.8	3.0	22.2	6.6	6.2
1971	100.0	25.8	16.4	8.2	17.7	2.5	19.6	5.4	4.3
1972	100.0	26.1	16.7	11.5	16.7	2.2	17.2	6.3	3.3
1973	100.0	27.0	16.4	13.0	15.0	2.1	16.6	6.3	3.7
1974	100.0	29.1	17.0	12.0	13.0	2.3	17.0	6.0	3.7
1975	100.0	27.3	15.9	12.4	14.9	2.6	16.3	6.0	4.7
1976	100.0	24.1	15.2	11.3	17.5	4.0	15.5	6.3	6.1
1977	100.0	22.4	15.0	13.7	17.2	3.3	14.9	7.6	6.1
1978	100.0	21.8	14.9	15.7	15.0	2.8	14.2	8.8	6.9
1979	100.0	22.7	14.0	15.1	13.8	2.7	14.0	8.1	9.7
1980	100.0	21.8	13.3	13.9	14.8	2.9	13.6	8.5	11.3
1981	100.0	20.9	12.5	13.1	15.2	1.8	11.0	10.0	15.6
1982	100.0	18.9	11.8	12.3	16.7	1.9	10.1	10.7	17.5
1983	100.0	17.4	11.3	11.6	18.1	2.6	9.4	10.9	18.8
1984	100.0	16.7	9.9	11.2	16.2	3.0	9.4	N/A	N/A
1985	100.0	17.3	9.3	11.5	12.0	3.1	8.3	N/A	N/A

[1] Totals may not add to 100.0 due to rounding.

[2] Includes commercial banks, mutual savings banks, and insurance companies through 1980. From 1981 on, excludes mutual savings banks, but includes money market funds.

[3] Includes S&Ls, nonprofit institutions, credit unions, corporate pension trust funds, dealers and brokers, certain U.S. Government deposit accounts, and U.S. government sponsored agencies. From 1981 on, also includes mutual savings banks.

N/A = Not available.

Source: Treasury Bulletin, various issues. Data for Federal Reserve and U.S. Government accounts are actual holdings; data for other groups are Treasury estimates.

mission, and some are specialized firms or separate subsidiaries of regulated firms that operate outside of the federal regulatory structure.

Secondary dealers are not subject to Federal Reserve Bank of New York oversight. They are not required to submit trading or financial data to the Federal Reserve Bank of New York (as primary dealers do daily) and are not subject to Federal Reserve Bank of New York dealer surveillance visits. However, in early 1984, the Federal Reserve Bank of New York requested that non-primary dealers voluntarily submit position, transaction, and financing data on a monthly basis in order to improve monitoring of the market. By June 1, 1984, only 26 dealers were reporting monthly and 7 daily.[4]

While the exact number of secondary dealers is not known, in part because there is no consensus definition of a dealer and in part because a number of these dealers are not registered with a Federal agency, published and other sources would suggest that there may be as many as 400 to 500 firms.[5] The Federal Reserve Bank of New York estimates that the majority of these secondary dealers are "regulated" in the sense that their government securities dealers operations probably take place within an otherwise regulated banking organization or within a Commission-registered broker or dealer. However, even with some of these regulated firms, the government securities activities may, in fact, take place in an affiliate or subsidiary which is not subject to Federal regulation. In addition, perhaps 100 or more government securities dealers are wholly unregulated at the Federal level.

The Treasury securities market performs four essential functions for the Federal Government. First, the market is the means through which the government finances current deficits. The Treasury sells securities to make up for any shortfall between revenues and outlays that occur as a result of actions taken by Congress and the Administration. Second, the market enables the Government to refinance maturing debt. Third, the market is the principal means through which the Federal Reserve System carries out monetary policy. With the buying and selling of Treasury securities, the Board of Governors of the Federal Reserve System [Federal Reserve Board] is able to influence the growth of the money supply and/or changes in the market interest rates and thus to influence the direction of economic activity. Fourth, the Federal Government uses the market to raise short-term funds (cash management bills) so that it can carry out its day-to-day cash management activities.

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[4] "Report on U.S. Treasury Securities—The Market's Structure, Risks and Regulations," a briefing report prepared by the General Accounting Office for the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, 99th Cong. 2d sess., Aug. 1986, p. 27 [GAO report].

[5] Statement of E. Gerald Corrigan before the Subcommittee on Securities, May 9, 1985. See also, "Survey on the Federal Reserve System's Supervision of the Treasury Securities Market: A Discussion Paper" prepared by the General Accounting Office for the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, 99th Cong. 1st sess. (GAO Survey), May 1985, pp. 12-13 (estimating 300 secondary dealers) and SEC Release No. 34-21959 (Apr. 23, 1985), 50 Federal Register 15905 [SEC Release] (estimating 200 secondary dealers).

The Government sells marketable and nonmarketable debt to finance its borrowing needs.[6] Most Treasury debt is marketable debt, which the Treasury sells to the public at auction. Marketable Treasury securities include Treasury bills, Treasury notes and Treasury bonds. Since the mid-1960's, the Treasury has been offering its securities to the market on a regularized schedule not directly affected by prevailing interest rates. Implementing this strategy, which is intended to help stabilize markets by reducing uncertainty about Treasury funding needs, involves weekly offerings of short-term obligations of less than 1 year, monthly offerings of obligations of 1 and 2 years, and quarterly offerings of intermediate-term notes (up to 10 years) and bonds (up to 30 years). At the end of 1985, marketable debt accounted for about 74 percent of total interest-bearing debt. Nonmarketable debt does not enter into the Treasury securities market.

The Federal Reserve Board uses the secondary market to execute domestic monetary policy. This is accomplished through the Open Market Desk of the Federal Reserve Bank of New York, which buys or sells securities outright or enters into repurchase agreements for the System Open Market Account, an account in which the Federal Reserve System holds Treasury securities. Moreover, banks, other financial institutions, insurance companies, pension funds and corporations are all important investors in Treasury securities. So, too, are foreign central banks and other foreign financial institutions.

The U.S. government securities market is the world's largest, most efficient and liquid securities market. Typically, tens of billions of dollars' worth of government securities are traded in a single day. This market provides an extremely efficient means for all participants to hold and trade government securities. The speed, efficiency and low transactional expense have contributed significantly to the liquidity and attractiveness of this market to investors.

In 1985, the Treasury raised a total of almost $1.2 trillion from the market in Treasury securities to finance the budget deficit and to refinance maturing debt.[7] This market consists of both a primary market through which new issues of U.S. government securities are sold to the public, and secondary markets in which outstanding government securities are traded. Over the last few years, the U.S. Government has had to raise more than $200 billion in new funds each year to finance the deficit, and it has had to refinance hundreds of billions of dollars of maturing debt.[8] Even larger volumes of trading will be necessary to accommodate the future growth of Government debt, which, under current policies as estimated by the Congressional Budget Office, will reach $2.5 trillion by the end of fiscal 1989.[9]

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[6] Federal debt comprises all securities issued by the Treasury and a small amount of debt issued in the past by executive branch agencies. Securities issued by the Treasury (public debt securities) comprise marketable issues held by the public, including the Federal Reserve and foreign investors; nonmarketable issues in the form of savings bonds; foreign series securities; State and local government series securities and nonmarketable issues for government accounts.

[7] GAO Report, p. 20.

[8] Id., p. 21.

[9] See, "The Economic and Budget Outlook: Fiscal Years 1987-91," Congressional Budget Office, February 1986, cited in GAO report, p. 76.

The need for legislation

The market in U.S. government securities is expanding, increasingly active, in recent years increasing volatile and, ironically, the least regulated securities market in this country. The expansion and volatility of the market has been driven by the amount of Federal debt to be financed, both new debt resulting from Government deficits and old debt that must be refinanced. In 1985, the Treasury needed to raise an average of over $4.8 billion a day in the credit markets.[10]

The lack of regulation results from the classification of government securities as "exempted securities" as defined in section 3(a)(12) of the Exchange Act. Although a majority of government securities dealers are subject to some form of federal supervision, brokers or dealers that execute transactions exclusively in government securities are not subject to supervision by any Federal regulatory agency since they trade only in exempted securities.[11] The absence of a coordinated regulatory structure for this market generally, and specifically for unregistered brokers and dealers, was cited in testimony before the Securities Subcommittee as a major factor in the recent failures of government securities dealers.[12]

Between July 1975 and April 1985, several failures of unregistered government securities dealers have occurred. The failures include Financial Corp. of Kansas City, Mo, 1975; Winters Government Securities, 1977; Drysdale Government Securities, 1982; Lombard-Wall, 1982; Comark, 1982; Lion Capital Group, Inc., 1984; and most recently E.S.M. Government Securities, Inc. [ESM] and Bevill, Bresler & Schulman Asset Management Corp. [Bevill, Bresler], 1985.[13]

The Commission has estimated that, since 1982, investors lost $900 million before recoveries from reduced income taxes, insurance claims, and civil suits. All of the dealer failures occurred in firms outside of the federal regulatory structure.[14]

In a written response to a question raised by Senator Riegle at the Securities Subcommittee's May 9, 1985 hearing, E. Gerald Corrigan provided an estimate of the losses resulting from the failures of Bevill, Bresler, ESM, Lombard-Wall, Inc., Lion Capital Group, Inc., Drysdale Securities Corporation and Winters Government Securities. In his letter, Mr. Corrigan stated: "[b]ased on some rough estimates, the losses from those failures are on the order of $800 million on a pretax basis. Among types of investors, losses to banks were about $325 million, thrifts around $375 million and municipal investors around $100 million." [15]

While each of these incidents had its own distinct traits, the Securities Subcommittee's analysis of recent problems suggests several features that were common to many of these failures. In a

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[10] GAO report, p. 75.

[11] See, section 15(a)(1) of the Exchange Act, 15 U.S.C. 78o(a)(1)(1984).

[12] See, Hearing on the Regulation of Government Securities Before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, 99th Cong., 1st Sess., May 9, 1985, S.Hrg. No. 99-161 (Subcommittee Hearing).

[13] See, GAO report, appendix VIII.

[14] GAO report, pp. 13-14.

[15] Letter to Senator Donald W. Riegle, Jr. from E. Gerald Corrigan, President, FRBNY, June 5, 1985 in Senate hearing, p. 83.

number of failures, the firm in question had issued apparently false and misleading financial statements. In others, problems in one company were masked by relationships, and at times complex transactions, with affiliated companies. Indeed, in some instances it would appear that investors may not have fully understood which entity was the counterparty to transactions. In yet other instances, it appears that the dealers in question used working capital generated by matched-book operations to engage in trading for their own account and in the process incurred losses because the customers failed both to know their counterparty and to secure control of the securities underlying a repurchase transaction with the problem dealer. The failure to know the financial status and management of the counterparty, and the failure to secure control of underlying securities not only ultimately resulted in the loss to the customer, but also had the effect of providing funds to the problem dealer, thereby permitting the dealer to continue operations in a way that may have disguised its true financial condition.

Circumstances surrounding the dealer failures cited above illustrate the risks that customers can encounter when dealing with firms in the government securities market. The failure of Lion Capital Group, Inc., in 1984 resulted in alleged losses before recoveries, if any, of approximately $40 million to about 60 customers. Many of these customers allegedly had engaged in repurchase agreements believing that the securities subject to repurchase were held on their behalf by Lion's clearing agent. Instead, Lion's clearing agent claimed it was holding these securities as security for loans it had made to Lion rather than in custody for Lion's customers. A similar situation occurred in the failures of ESM and Bevill, Bresler in 1985. Many of their repurchase agreement customers found that the securities underlying their transactions were claimed by other parties. It appears that in many instances government securities purportedly held for the benefit of customers had been resold or otherwise converted for use by the failed firm or perhaps were never held by the failed firm.

The failures of ESM and Bevill, Bresler also demonstrate weaknesses in the regulatory framework of the government securities market. ESM, an unregistered government securities dealer, allegedly failed for over 5 years to reflect in its financial statements the fact that it had incurred substantial losses from trading reverses and high expenses incurred by the firm. ESM allegedly was able to continue operating despite these losses because it issued inaccurate financial statements and because its customers were not adequately collateralized in their transactions.

The April 1985 bankruptcy of Bevill, Bresler, an unregistered government securities dealer, seems to have resulted from the provision of financing for a related government securities firm which had incurred large trading losses. Bevill, Bresler allegedly engaged in repurchase transactions with customers of its affiliated registered broker-dealer. Bevill, Bresler seems to have been able to continue operating, in part, because customers did not take delivery of the securities underlying repurchase agreements.

The destabilizing effects upon the financial markets of the failures of two relatively small government securities firms must not be underestimated. For example, ESM's failure resulted in losses of

over $300 million to local governments and certain saving and loan associations, which precipitated a depositors' run on thrift institutions in Ohio that resulted in the temporary closing of 71 Ohio thrift institutions. The run on the Ohio thrifts precipitated a sharp rise in the price of gold in European markets and a corresponding drop in the value of the dollar. The gold and foreign currency markets responded in a similar fashion after the failure of Bevill, Bresler.

The need for legislation was expressed on several occasions in correspondence to and testimony of witnesses appearing before the Securities Subcommittee.[16] Although he initially questioned the need for regulating the government securities market, Commission Chairman Shad noted in a letter to Committee Chairman Garn that a precisely crafted regulatory structure was appropriate.[17] In describing the role of an relationship between the Federal Reserve Bank of New York (FRBNY) and the participants in the market, FRBNY President E. Gerald Corrigan stated:

> This evolution of the Fed's interest in the government securities market took place, *however, in a framework in which the Fed had and continues to have no express statutory authority.* At the same time, the sheer growth of the debt as well as advances in communications and technology have made it possible for hundreds of new firms to enter the government securities business and operate nationwide from virtually any location in the country. * * *
>
> The current arrangements, especially as extended to the secondary dealers, may not be adequate for the future. *For example, by having an informal monitoring role, we may create an appearance of providing much greater protection from abuse than is justified.* Moreover, given our present role, we have to be careful in dealing with suspected problems—indeed there may be circumstances where efforts to move in on a situation could create difficulty where none existed, or could make a large problem out of a small one. Some danger of this type probably exists with any regulatory function, but it may be especially acute in the case of the government securities market, given the intricate

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[16] See, SEC Release No. 34-21959, (April 19, 1985) 50 FR 15904 (SEC Release). The majority of the responses to the Commission request (SEC Release) for comments on the oversight of the U.S. government and agency securities market supported some form of regulation of the government securities markets. Of the 79 comment letters the Commission received, 56 commentators supported some form of regulation for the government and agency securities markets, 12 commentators opposed any form of further regulation and 11 expressed no opinion.

See also, "Regulation of the Government Securities Market," Report by The Securities and Exchange Commission to the Subcommittee on Telecommunications, Consumer Protection and Finance of The Committee on Energy and Commerce of the U.S. House of Representatives, June 20, 1985, Exhibit 2 (SEC Report).

A substantial majority of the panelists participating in the Commission's May 21, 1985 Public Forum on the Government Securities Market believed that some regulation of the government securities market was necessary to restore confidence in the markets and in dealers, particularly secondary dealers, to prevent dealer firm problems, and to protect less sophisticated institutional investors. See, Transcript of the Commission's Public Forum on Government Securities markets, May 21, 1985, (Commission Public Forum), pp. 72-73, 75-78, 81-83, 111-122, 126-135, 161-190, 193-201, 212-219.

[17] Letter to Chairman Jake Garn from Commission Chairman Shad, Treasury Secretary James A. Baker, III and Federal Reserve Board Chairman Paul A. Volcker, April 8, 1986 (Regulators' Letter). Letter on file with the Senate Committee on Banking, Housing and Urban Affairs.

> interdependence of that market with so may other parts of the financial structure. Since there can never be a fail-safe system of surveillance or even of regulation, I believe that recognition of these problems must be central to our thinking as we seek ways to guard against abuses while at the same time seek to preserve the strength and dynamism of the market.[18] (Emphasis supplied)

Richard M. Kelly, Chairman of the Public Securities Association's division on Government and Federal Agency Securities also advocated the need for federal regulation of the participants in the government securities market. In testimony before the Committee, Mr. Kelly stated:

> The Primary Dealers Committee is very concerned about these recent failures and the long-term effects they may have on public confidence in the government securities market. For this reason, we believe that the best interests of the market and its customers would be served by legislation which establishes rulemaking authority with the Federal Reserve Board for application to all government securities dealers and brokers (and their government securities subsidiaries and affiliates. We would suggest that this authority be exercised with measured restraint to address only identifiable weaknesses in the market. In addition, this legislation should require Fed consultation with the Treasury Department and other appropriate regulatory agencies before approval of any rules.[19]

The legislation is also needed to maintain public confidence in the government securities market and to ensure that it remains a liquid and efficient market. After the failures of ESM and Bevill, Bresler, some investors in government securities withdrew from the market.[20] The loss of participants in the market has a negative effect on the liquidity of the market and thereby may adversely affect the Treasury's ability to finance the national debt.

Moreover, this legislation addresses the concern that liquidity in the market would be adversely affected due to the tendency of some investors in government securities, in the aftermath of the failures of ESM and Bevill, Bresler, to limit their dealings only to large firms or primary dealers. In reaction to the ESM and Bevill, Bresler failures, market participants observed that many secondary dealers were experiencing a "blind flight" to quality by investors choosing to deal only with primary dealers under the mistaken assumption that they are regulated by the Federal Reserve Board.[21] FRBNY

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[18] Statement of FRBNY President E. Gerald Corrigan before the Securities Subcommittee on May 9, 1985. Senate Hearing, pp. 63–64.

[19] Although the Public Securities Association's initial proposal contemplated investing rulemaking authority in the Federal Reserve Board, its support of a version of S. 1416 which invests the Secretary of Treasury with rulemaking authority is stated in a July 21, 1986, letter to Senator Garn. Letter to Honorable Jake Garn from Jon S. Corzine, Chairman, Public Securities Association. Letter on file with Senate Committee on Banking, Housing and Urban Affairs.

[20] See, Commission Public Form, pp. 44–47, 103–104 and SEC Report, p. 17. See also, "Local Governments are Shying Away From Bond Dealers," Wall Street Journal, August 19, 1985, p. 29.

[21] See, Commission Public Forum, pp. 44, 73, 85–87, 110, 125–126, 136–143, 149–151, 197–199, 217–218.

President E. Gerald Corrigan, in a written response to Senator Sasser, acknowledged that customer flight could eliminate many secondary dealers that add capital to the market and service smaller institutions.[22] Without the assurances provided by a coordinated Federal regulatory framework, some investors may continue the trend to execute transactions solely with primary dealers, to the detriment of secondary dealers, thereby adversely affecting the liquidity and efficiency of the government securities market.

The witnesses appearing before the Securities Subcommittee emphasized that the Committee should proceed with caution in drafting legislation to seek a higher level of assurance that the problems of the past will not be repeated. When questioned about the appropriate form of legislation to regulate the government securities markets, the witnesses responded that the most effective legislation would provide for: (1) registration of government securities dealers at the Federal level; (2) establishment of financial responsibility safeguards such as capital adequacy requirements; (3) procedures for the acceptance and use of customers' securities; (4) reporting requirements; (5) safeguards to deter fraudulent practices in connection with repurchase transactions; and (6) onsite inspection and enforcement authority by the Federal regulators.[23]

In light of the testimony received by the Securities Subcommittee, a study prepared by the Commission,[24] comment letters [25] to and testimony received by the Commission,[26] the Committee determined that legislation regulating the government securities market must accomplish three purposes: first, the legislation should incorporate the safeguards cited above to maintain a fair and orderly market in government securities; second, the regulation of the government securities market should not adversely affect the liquidity and efficiency of the market; and third, the legislation should, where possible, rely upon existing regulation, since many government securities brokers and dealers are already subject to some form of Federal regulation. The legislation is specifically designed to satisfy these requirements and to protect the public interest in the government securities market. Because the legislation addresses identified weaknesses in the government securities market, it would not result in excessive regulation that would impair the efficient operation of the market, increase the costs of financing the Federal debt or compromise the execution of domestic monetary policy.

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[22] FRBNY President E. Gerald Corrigan stated in pertinent part:

"This is a cause for some concern since such actions, should they become widespread, would tend to limit access to the market by not only weak or poorly capitalized firms—a desired effect—but by well-managed firms as well. Many small and medium-sized dealers are well-capitalized and perform a helpful and important function in the operation of the market. They provide liquidity in this nationwide market by matching purchasers and sellers of securities."

Letter to Senator James R. Sasser from E. Gerald Corrigan, President, Federal Reserve Bank of New York, June 11, 1985, in Subcommittee Hearing, p. 85.

[23] See, Statement of E. Gerald Corrigan before the Securities Subcommittee on May 9, 1985, Senate Hearings at p. 76; statement of Richard Kelly before the Securities Subcommittee on May 9, 1985, Senate Hearing, pp. 93–94. See also, Regulators' Letter.

[24] See, SEC report, pp. 28–34.

[25] See, Comment letters filed with the Commission in response to SEC Release.

[26] The most prevalent forms of regulation proposed by the participants at the Commission's Public Forum included registration requirements, some qualifications standards, capital adequacy standards, reporting and recordkeeping requirements and regular firm inspections. Commission Public Forum, pp. 111–122, 126–135, 161–190, 193–201.

REGULATION OF THE GOVERNMENT SECURITIES MARKET

The legislation adds a new section to the Exchange Act, section 15C, and provides for various conforming amendments to the Exchange Act, the Investment Company Act of 1940 and the Investment Advisers Act of 1940. The legislation requires currently unregulated government securities brokers and dealers to register with the Commission and other government securities brokers and dealers, specifically primary dealers, registered brokers and dealers and financial institutions, to file a notice with their appropriate regulatory agencies.

In addition, the bill grants specific rulemaking authority to the Secretary of the Treasury [Secretary] to adopt rules regarding: financial responsibility including capital adequacy, custody and use of customers' securities, and the transfer and control of government securities in repurchase transactions; financial statements; and recordkeeping and exemptions from registration. The enforcement of these rules would be the responsibility of the Commission as to currently registered brokers and dealers and those government securities brokers and dealers required to register with the Commission under the bill. The enforcement of the rules promulgated by the Secretary would be the responsibility of other appropriate regulatory agencies as to primary dealers, banks and other institutions specified in the bill. The bill would also provide that all newly registered government securities dealers would have to join a registered securities association.

Government securities would continue to be treated as exempted securities for purposes of the Exchange Act. Therefore, the registered securities association would have no new authority with respect to government securities brokers, government securities dealers, or government securities transactions except as specifically authorized in the bill or as already exists in current law.

At present, brokers and dealers doing business in only government securities are exempt from regulation. The bill requires, for the first time, brokers and dealers engaged exclusively in the business of buying and selling government securities to register with the Commission pursuant to procedures provided in the legislation. Brokers and dealers already registered with the Commission by reason of their general securities business would not be required to re-register. Financial institutions already subject to the regulatory jurisdiction of another Federal Government agency and primary dealers would not be required to register.

Brokers and dealers currently registered with the Commission, financial institutions and primary dealers would be required to notify the appropriate regulatory agency of their status as a government securities broker or government securities dealer. The appropriate regulatory agency, upon the receipt of these notices, would be required to furnish them to the Commission. Registration with the Commission by currently unregulated government securities brokers and dealers and the filing of notices with the appropriate regulatory agencies by other government securities brokers and dealers will make it possible to determine the identity of government securities brokers and dealers and the scope of the government securities markets.

The legislation invests the Secretary with the rulemaking authority due to the expertise of the Treasury in these markets and to ensure that the rules will accomplish the purposes of the bill. Questions have been raised concerning the level of the Treasury's expertise as a rulemaker and the existence of a potential conflict of interest between the Secretary's responsibilities as the rulemaker and as the issuer of the debt.[27] However, the Committee is confident that the Secretary will fully and faithfully pursue the rulemaking authority granted in this legislation for the following reasons.[28]

The selection of the Secretary as the rulemaker was premised upon the Treasury's commitment to promulgate rules to regulate government securities brokers and dealers and its relationship with the participants in the government securities markets. Contrary to the perception of the Treasury's position when the issue regarding such regulation first arose, the Secretary submitted a legislative proposal to President of the Senate Bush in December 1985 that provided for many of the safeguards contained in the legislation.[29] Further, the Secretary has taken a firm position in support of the bill, as indicated by Treasury Secretary Baker's letter of April 8, 1986, and Under Secretary Gould's letter of August 12, 1986.[30]

As the manager of the public debt, the Treasury is responsible to Congress for managing that debt at the lowest possible cost. Therefore, the Secretary has the need for and responsibility to maintain a liquid and efficient market that has the continuing confidence of investors. The Treasury has demonstrated its commitment to the responsible operation of the government securities market through the implementation of procedures regarding when-issued trading, the innovation of Separate Trading of Registered Interest and Principal of Securities [STRIPS], the introduction of the Treasury DIRECT book-entry program, the provision of State securities accounts at the Federal Reserve Banks, and the new proposed book-entry regulations.

The Treasury also controls the system that keeps track of the ownership of government securities that are held in registered form or, if in book-entry form, either in direct accounts with the Treasury or by depository institutions that have securities accounts with the Federal Reserve Banks. This system is operated in part by the Federal Reserve System, the Treasury's fiscal agent, which operates the closely related securities and funds transfer systems. Such securities transfers and the payments therefor are carried out through FedWire, a dedicated Federal Reserve telecommunications system.

The business relationship the Federal Reserve Bank of New York has with primary dealers (and those seeking to become primary dealers) is protected by this legislation. The legislation enhances

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[27] See, Statement of Governor Aulana Peters before the House Subcommittee on Telecommunications, Consumer Protection and Finance of the House Committee on Energy and Commerce, June 29, 1985.

[28] See, regulators' letter and letter to Chairman Jake Garn from George D. Gould, Under Secretary, Department of the Treasury, August 12, 1986 (Under Secretary Gould's Letter). Letter on file with the Committee on Banking, Housing, and Urban Affairs.

[29] Letter to Vice President George Bush from Treasury Secretary James A. Baker III, December 6, 1985. Letter and legislative proposal on file with the Committee on Banking, Housing, and Urban Affairs.

[30] See, regulators' letter and Under Secretary Gould's letter.

the enforcement authority over banks and bank holding companies under jurisdiction of the Federal Reserve Board. In addition, the Federal Reserve Board is assigned new inspection and enforcement responsibilities for the primary dealers.

The Secretary was chosen as the rulemaker due to the need for effective coordination among the interested federal agencies. This coordination is especially critical at this time in view of the current rapid pace of both innovation in and the globalization of the government securities market. The Secretary, as chief financial officer of the United States, has close and well-established relationships and longstanding institutional ties with the other government agencies, at both policy and operating levels, which help assure effective communication and a cooperative approach in dealing with current market problems. The statutory role of the Federal Reserve Banks, for example, as fiscal agents of the Treasury in the government securities market, has fostered day-to-day working relationships and a degree of interdependence that assures that the resources and concerns of both institutions will be effectively focused on market problems as they develop.

The selection of the Secretary as the rulemaker will not create any potential conflicts of interest of a type or variety that would exist if the Federal Reserve Board or a self-regulatory organization were granted rulemaking authority. The Secretary will not favor Treasury securities over the securities of Government agencies or Government-sponsored corporations through the imposition of costly and unnecessary regulation of transactions in the securities of such agencies or corporations. Further, the conflicts of interest that arise in the issuance of nonexempt corporate securities are not present in the issuance of Treasury securities by the Secretary. No conflict will be presented to the Treasury regarding its credit standing, mechanisms for issuance, underwriters' compensation or affiliations, insider transactions, or similar issues that arise for corporations that are properly subject to Commission jurisdiction for their securities issues.

Since rulemaking authority is vested in the Secretary, the establishment of a new self-regulatory organization becomes unnecessary. Moreover, the legislation affords significant advantages over granting rulemaking authority to an existing self-regulatory organization such as the Municipal Securities Rulemaking Board [MSRB]. The creation of a new self-regulatory organization would fail to take advantage of existing regulatory structures and would be unnecessarily duplicative and expensive. To grant rulemaking authority to the MSRB, or a self-regulatory organization created specifically to regulate the government securities market, would be unwarranted.[31]

The establishment of such a structure would fail to recognize the important difference between the municipal and government securities markets. Unlike the municipal securities market, which is a retail market in which individual investors play a significant role, the government securities market is essentially a wholesale market

[31] An overwhelming majority of the participants at the Commission's Public Forum opposed expanding the authority of the MSRB or creating a separate government securities rulemaking board. Commission Public Forum pp. 97-105, 167-170, 201-203.

dominated by institutional investors. In addition, the abuses which existed in the municipal securities market and which led to its regulation, particularly fraudulent trading and selling practices, are different in nature from the problems that have surfaced in the government securities market, which appear largely to involve unregulated dealers engaging in imprudent and in some instances fraudulent activities involving the handling of funds and securities. The ESM and Bevill, Bresler failures, for example, involved ostensibly fraudulent abuses in the use of repurchase agreements.

Granting rulemaking authority to an existing self-regulatory organization such as the MSRB, or a new self-regulatory organization, would also fail to recognize the critical importance of the government securities markets in financing the Federal debt and in the coordination of national economic policy, and the Treasury's preeminent role and expertise in this regard. In exercising the rulemaking authority provided by this legislation, the Treasury is well-suited to take into account the particular characteristics of the government securities market and to recognize relevant differences between the government securities market and the corporate and municipal securities markets.

Finally, the Treasury is preferable to a self-regulatory organization as a rulemaker for the fundamental types of regulations this bill requires. Since the Securities Acts Amendments of 1975, the self-regulatory organizations have not been relied upon to establish basic, minimum financial responsibility rules for registered broker-dealers. This change was a direct result of "the crisis period of 1968 through 1970" when some member firms were permitted to continue in business to the jeopardy of their customers because some exchanges adopted liberal interpretations of their financial responsibility requirements.[32] Similarly, section 17(e)(1)(A), added to the Exchange Act in 1975, rather than self-regulatory organization rules, contains the requirement for broker-dealer annual audited financials.[33] Even before 1975, section 17 of the Exchange Act authorized the Commission to establish basic recordkeeping and reporting requirements for broker-dealers.

The legislation would grant to the Secretary specific rulemaking authority in the areas of financial responsibility and related practices, financial statements, recordkeeping and exemptions from registration. Rulemaking authority in additional areas does not appear to be necessary to address the weaknesses that have been identified in the government securities markets. The committee intends that the Secretary, in exercising rulemaking authority under the bill, will account for the differences between types of transactions engaged in by brokers or dealers participating solely in the markets for securities of Government agencies and Government-sponsored corporations and transactions of brokers or dealers participating in the general market in government securities.

In adopting the rules under section 15C, the Secretary shall consult with and consider the views of the Commission and the Feder-

[32] Securities Reform Act of 1975, Report of the Committee on Interstate and Foreign Commerce, U.S. House of Representatives, 94th Cong., 1st Sess., April 7, 1975 (Rept. No. 94-123) ("House report"), pp. 49 and 76. Securities Acts Amendments of 1975, Conference Report to accompany S. 249, 94th Cong., 1st Sess., May 19, 1975 (Rept. No. 94-229) p. 104.

[33] See House report, p. 77.

al Reserve Board, except where the Secretary determines that an emergency requires expeditious and summary action. The requirement that the Secretary consult with the Commission and the Federal Reserve Board is intended to avert conflicting regulation of government securities brokers and dealers and to ensure that the Secretary takes account of all aspects of a proposed regulatory action. The Secretary would be further directed to respond in writing to any written comments submitted by the Commission or the Federal Reserve Board on any proposed rule that has been published for comment. The Committee anticipates that the Secretary would consult with the Commission and the Federal Reserve Board informally, orally or in writing, before proposing such rules, and that a written response from the Secretary would be required to written comments of the Commission or the Federal Reserve Board unless waived by the Commission or the Federal Reserve Board. The written response requirement is intended to facilitate interagency communication, but not otherwise to limit the authority of the Secretary or to create any legally enforceable right or benefit.

The Committee also expects that the Secretary, to the extent the Secretary deems appropriate, would also solicit and consider the views of the appropriate regulatory agencies having enforcement responsibility under section 15C and of other issuers of government securities, in addition to requesting public comment in accordance with established rulemaking procedures prior to the final adoption of any rules under section 15C. Similarly, the Committee expects that the appropriate regulatory agencies would solicit and consider the views of the Secretary in connection with their promulgations of notice and registration rules required by section 15C(a) for government securities brokers and government securities dealers.

The legislation invests the Commission with the authority to register or deny registration to brokers and dealers required by this bill to register with the Commission and to promulgate rules regarding the form of registration and the type of information required to be submitted for registration as well as the form and information required for withdrawal from registration. The appropriate regulatory agency is empowered to prescribe the form of notice required to be filed by currently registered brokers and dealers, financial institutions, and primary dealers.

The legislation requires the Secretary to promulgate rules relating to financial responsibility. The rules related to financial responsibility include minimum net capital requirements. Net capital requirements for government securities brokers and dealers should be designed to assure that all brokers and dealers in the markets for Treasury, government agency and government-sponsored corporation securities are financially responsible. The Committee expects that the Secretary will take into consideration in formulating capital adequacy rules the type of government securities transactions in which brokers and dealers engage. The Committee expects that the Secretary will formulate different capital adequacy rules for each class of government securities brokers or dealers depending upon the type of government securities transactions in which these brokers or dealers engage. For example, brokers or dealers that solely engage in transactions in the securities guaranteed by government agencies, such as the Government National Mortgage

Association [GNMA] or the Small Business Administration [SBA], or in securities issued by government-sponsored corporations, such as the Federal Home Loan Mortgage Corporation [FHLMC], the Federal National Mortgage Association [FNMA], or the Student Loan Marketing Association [SLMA], have different structures than brokers and dealers who engage in a more general government securities business. Thus, brokers and dealers that limit their activities to transactions in government agency or government-sponsored corporation securities may be subjected to lower capital adequacy requirements to take into consideration the nature of the transactions in which they engage consistent with the purposes of this Act.

The rules would also establish safeguards with respect to related practices of government securities brokers and dealers, including the acceptance of custody and use of customers' government securities, the carrying and use of customers' deposits or credit balances and the transfer and control of government securities in repurchase agreements and similar transactions.[34] In addition, the Secretary would be obligated to adopt rules relating to financial statements and recordkeeping requirements for government securities brokers and dealers.

In adopting rules under Section 15C, the Secretary must consider the adequacy of rules already applicable to registered broker-dealers, financial institutions, and primary dealers. Section 15C(b)(3)(A) authorizes the Secretary to exempt government securities brokers or dealers from the rules under Section 15C in areas where such brokers or dealers already are adequately regulated. As a result, the Secretary should be able to avoid applying duplicative and unnecessarily costly requirements to brokers and dealers registered under section 15 of the Exchange Act and financial institutions, which are already subject to Federal regulation in areas covered by section 15C(b). This exemptive authority is intended to avoid, to the maximum extent consistent with achieving the objectives of the bill, subjecting registered broker-dealers and financial institutions to conflicting or unduly burdensome regulation in the areas of financial responsibility or recordkeeping.

The Committee views these rules as being generally sufficient to achieve the purposes of the rules to be adopted under section 15C(b), and would expect an affirmative determination of their adequacy under section 15C(b)(3)(A) for most core regulation of the majority of such institutions other than primary dealers. The Secretary may condition such a determination of adequacy upon an ap-

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[34] The Committee recognizes that in certain circumstances, such as overnight repurchase agreements in GNMA's, a physical delivery requirement might have adverse consequences on the efficiency and liquidity of the government securities market. Until a comprehensive book-entry system for GNMA and other certificated government securities is developed, a physical delivery requirement would be impractical. With regard to other repurchase agreements, the Committee expects the Secretary to adopt rules requiring the physical delivery of government securities to a customer in connection with these repurchase agreements only after consideration of less expensive alternatives such as segregation of customers' securities and procedures for credit analysis and review of counterparties would not effectuate the purposes of the Act, and that such a requirement is feasible and justifiable given the need to protect the liquidity of the government securities market. The physical delivery requirements for different repurchase agreements would take into account the length of the repurchase agreement. Since fraud in connection with repurchase transactions was the cause of recent government securities dealer failures, the Committee intends that the rules promulgated by the Secretary seek to improve the mechanisms for the transfer and control of securities in repurchase agreements to deter recurrence of the abuses seen in recent failures.

propriate regulatory agency's revision of its rules. The Committee expects the Secretary and the appropriate regulatory agencies to communicate in advance of any such determination, and to cooperate with one another both in this process and in future rulemaking to assure that the rules of each agency applicable to the various types of regulated entities will achieve the purposes of the rules to be promulgated under section 15C(b) consistent with the statutory mandates of those agencies.

To preserve flexibility and to guard against negative effects on the efficiency and liquidity of the government securities markets, the Secretary would also be empowered to exempt any government securities broker or dealer or category of government securities broker or dealer from registration or any rules or regulations that the Secretary promulgates pursuant to this legislation.

The exemptive authority granted to the Secretary in sections 15C(a)(4) and 15C(b)(2) of the legislation is not intended to be used to discriminate against certain classes of government securities brokers or dealers, especially those government securities brokers or dealers trading exclusively in securities issued or guaranteed by Government agencies or Government-sponsored corporations. With respect to sections 15C(a)(4) and 15C(b)(2) of the Exchange Act, which would allow the Secretary to classify and exempt certain government securities brokers and dealers from certain provisions and rules under this section, the Secretary shall consider the burden on competition which such exemptions would place on other classes of Government securities brokers or dealers lacking similar exemptions and the attendant harm to the liquidity of the markets the regulated brokers and dealers serve. Section 23 of the Exchange Act as amended by this bill would prohibit the imposition of a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. Thus, inappropriate discrimination against government securities brokers or dealers who do not trade Treasury securities would be unlawful. For example, if brokers and dealers who confined their activities to Treasury securities were granted exemptions from the capital adequacy rules or Commission registration requirements, while brokers and dealers of GNMA, FHLMC, and FNMA mortgage-backed securities and SBA securities were not, those brokers and dealers who would otherwise be active in making a market in mortgage-backed or SBA securities may be inclined to discontinue their activities in those securities and to pursue market activities with respect to government securities that would not require broker-dealer registration with the Commission. Such discriminatory treatment would be highly detrimental to the secondary mortgage marketplace or the secondary market for SBA guaranteed loans (markets in which GNMA, FHLMC, and FNMA mortgage-backed or SBA securities play a major role in providing liquidity and efficiency), and would thus be contrary to the public interest requirements of this section.

To ensure compliance by all government securities brokers and dealers and associated persons with section 15C and rules promulgated by the Secretary thereunder, the bill would provide for use of federal regulatory agencies to perform inspection and enforcement functions. The Commission would have jurisdiction over currently

registered brokers and dealers and government securities brokers and dealers required to register with the Commission under section 15C, as well as persons associated with them. Other government securities brokers and dealers, and associated persons, would be subject to the oversight of the appropriate regulatory agency depending on the identity of the government securities broker or dealer. The appropriate regulatory agencies include the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the Federal Savings and Loan Insurance Corporation. The Commission and other appropriate regulatory agencies would be empowered to impose sanctions on government securities brokers and government securities dealers and associated persons for violation of new section 15C or the rules thereunder. The risk of inconsistent enforcement by dividing enforcement authority among the Commission and other regulatory agencies is minimal and plainly outweighed by the benefit of having such agencies regulate parties with which they have the greatest familiarity.

Consistent with the concept of functional regulation, the Commission is granted inspection and enforcement jurisdiction over bank holding company nonbank subsidiaries and national bank operating subsidiaries that act as government securities brokers or dealers. Nevertheless, section 15C(f)(1) makes clear that the bill does not limit the existing jurisdiction of the bank regulatory agencies, the Secretaries of the Treasury and Housing and Urban Development, GNMA, or the Commission, except as provided in section 15C(f)(2). This regulatory structure is intended to preserve the existing enforcement, inspection and supervisory authority of the bank regulatory agencies over the banking and nonbanking operations for which they are responsible under current law. For example, the Federal Reserve Board would have its current jurisdiction over bank holding company nonbank subsidiaries that act as government securities brokers or dealers, and the Comptroller of the Currency would have its jurisdiction over national bank operating subsidiaries that act as government securities brokers or dealers. The Commission retains its current enforcement authority over financial institution-government securities brokers and dealers with regard to provisions of the Exchange Act other than section 15C.

Information, including, but not limited to, that contained in bank examination reports received by the Secretary or an appropriate regulatory agency from or with respect to a government securities broker, government securities dealer or associated person may be made available, upon request or at the recipient's initiative, to the Commission, the Secretary, an appropriate regulatory agency or a self-regulatory organization. To be shared under this provision of the bill, information should be relevant to the duties or authority under the bill of the entity with which it is shared. This provision is intended to ensure that, where an agency has reason to question the activities of a government securities broker or dealer not directly under its jurisdiction, it will pass the information on to the appropriate regulatory agency or the Secretary. All relevant information necessary to uncover fraudulent activity and to facilitate the identification of persons who have committed such violations is

expected to be shared, not just formal reports of examination or other such reports.

Government securities brokers and government securities dealers

The legislation creates two new categories of Commission registrants designated as "government securities broker," and "government securities dealer." Both terms would utilize key concepts from the current definitions of "broker," [35] "dealer," and "municipal securities dealer." [36] In this regard, the Committee has specifically employed the concept of "engaged in the business" in the definition of both "government securities broker" and "government securities dealer." The concept of "engaged in the business" would be interpreted by the Commission to carry out the purposes of section 15C of the Exchange Act.[37] Accordingly, the Commission may determine that corporations that are active in the government securities market as investors for cash management purposes are not "engaged in the business." Where issues are presented that are particularly related to the government securities activities of potential registrants, the Committee expects the Commission to consult with the Secretary when necessary.

Where traditional interpretations of language used in defining broker, dealer, and municipal securities dealer suggest that registration is required in a particular situation, the Secretary, nevertheless, has the authority to exercise the exemptive authority provided in the legislation to implement the policies of the bill. This exemptive authority allows the Secretary the flexibility of developing practical and workable means of regulating the government securities industry and trading in government securities.

The bill is not intended to reach certain activities of persons registered with or otherwise overseen by the Commodity Futures Trading Commission [CFTC], such as futures commission merchants, commodity pool operators, clearing organizations, floor brokers or floor traders, whose purchases, sales, or other transactions in government securities may be for their own proprietary account or as agent for customer-related business which is subject to CFTC oversight.

These commodity professionals often buy and sell government securities as an incidental part of their futures or options business, either for cash management purposes or as agent in connection with their customers' trading activities for margin or other related

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[35] The definition of "government securities broker" differs from the definition of "broker" in section 3(a)(4) of the Exchange Act in two key respects. It does not contain an exception for banks and it includes the limitation that the definition is applicable only to those "regularly" acting as a broker.

[36] The definition of government securities dealer is based upon the definitions of the terms "dealer" and "municipal securities dealer" in sections 3(a)(5) and 3(a)(30) of the Exchange Act. It is intended that the principles applied in determining whether a person is a dealer for the purposes of section 3(a)(30) would also be applied in determining whether a person is a government securities dealer. Thus, for example, a person who engages in transactions for its own account with government securities dealers who have registered or filed notice under new section 15C(a) and not with the public, would not, in most cases, be considered to be "engaged in the business" of being a government securities dealer, absent an indication that the person was holding itself out as a dealer in government securities, acting as an underwriter for issuers of government securities, or carrying a dealer inventory in government securities.

[37] The Committee expects that the Commission will exercise its interpretive and no-action authority in the determination of whether or not registration under section 15C(a)(1) is required. See, 17 CFR § 200.81.

purposes. The Committee intends that the Commission would consult with the CFTC whose expertise is essential in determining whether or not particular activities of persons registered with the CFTC are incidental to that person's regulated options and futures business. If it is found that firms under the CFTC's jurisdiction are acting as government securities dealers, then the regulatory provisions of the bill would apply to their activities.

The bill also makes use of a new definition, "registered broker or dealer," to indicate which provisions of the Exchange Act are applicable only to brokers and dealers that do not limit their securities activities to exempted securities. Sole government securities brokers and government securities dealers would not be registered broker-dealers for most purposes, including the Securities Investor Protection Act. Under the provisions of section 3(a)(2)(A) of the Securities Investor Protection Act of 1970, those entities registered pursuant to section 15C would not be members of the Securities Investor Protection Corporation [SIPC].

The role of self-regulatory organizations

The legislation recognizes the importance of self-regulation as the principal means by which compliance with the regulatory requirements of this legislation ultimately will be achieved by the securities industry. Accordingly, section 15C provides that all government securities brokers and dealers which are required to register with the Commission pursuant to section 15C would also be required to become members of a registered national securities exchange or a registered securities association. Conforming amendments would specifically provide that a registered securities association or a national securities exchange may admit government securities brokers and dealers as members.

Such an association would perform supervisory and enforcement functions with respect to government securities brokers and dealers required to register with the Commission pursuant to section 15C. Since government securities would continue to be treated as exempted securities for purposes of the Exchange Act, a registered securities association would have no authority with respect to government securities brokers, government securities dealers, and government securities transactions except as specifically authorized in the bill or as already exists in current law. The authority under the bill would consist, most significantly, of the power to enforce compliance by government securities brokers and government securities dealers with section 15C and the Secretary's rules thereunder, to provide for discipline of members and to examine books and records, as well as such other powers as are specified in the bill.

Aside from the areas of regulation described in section 15A(f)(2), a registered securities association would not be authorized to regulate transactions in exempted securities by member brokers or dealers. For example, a registered securities association would be precluded from adopting, under section 15A(b)(6), any rules of fair practice applicable to government securities brokers and government securities dealers or from establishing any standards of financial responsibility, operational capability or competence with respect to government securities brokers, government securities dealers or their associated persons.

However, subsection (F) of section 15A(f)(2) empowers registered national securities associations to adopt rules prohibiting fraudulent, misleading, deceptive and false advertising.[38] This rulemaking authority is designed to deter misleading statements regarding yields available on securities issued or guaranteed by GNMA or similar mortgage-related securities.[39] The statements intended to be covered by this provision are those advertisements or promotional materials that would be directed to retail customers.[40]

This provision permits the National Association of Securities Dealers [NASD], subject to approval by the Commission, to use its authority to promulgate advertising rules. Currently, section 15A(f) of the Securities Exchange Act does not confer upon the NASD the authority to make rules concerning trading in exempted securities. GNMA securities are exempted securities under section 3(a)(12) of the Exchange Act. Thus, for those brokers or dealers who are not exchange members, no authority currently exists to promulgate advertising rules. By contrast, GNMA mutual fund shares are not exempted securities and thus the NASD's rules currently apply. A registered securities association would only be authorized to make rules for specific enumerated purposes concerning transactions in government securities, including the prohibition of fraudulent, misleading, deceptive and false advertising.

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[38] The need for this provision was articulated in a letter to Senator Garn from Glenn R. Wilson, Jr., President, Government National Mortgage Association. Letter on file with the Committee on Banking, Housing and Urban Affairs. Referring to S. 1416, Mr. Wilson stated:

"Just as importantly, Section 203 of the bill would allow a registered securities association to 'prohibit fraudulent, misleading, deceptive, and false advertising.' This provision is necessary because many investors continue to be misled by advertising appeals and prospectus reports which fail to adequately address yield calculation, price fluctuations, investment risk factors, extent of the government guarantee, and other characteristics unique to the GNMA security which will assist the average investor in making an informed decision.

"Although GNMA has no specific regulatory authority on this subject, we are working with the Securities and Exchange Commission, the North American Securities Administrators, the National Association of Securities Dealers, the Investment Company Institute and other agencies to develop advertising standards for government securities." * * *

"By granting to registered securities associations the specific authority to implement advertising regulations, this legislation would reinforce the efforts of GNMA and other groups mentioned above to promote voluntary actions aimed at protecting individual investors, by both the public sector and broker-dealers themselves."

Letter to Chairman Jake Garn from Glenn R. Wilson, Jr., President, Government National Mortgage Association, August 11, 1986. Letter on file with Senate Committee on Banking, Housing, and Urban Affairs.

[39] Subsequent to the introduction of S. 1416, problems regarding the calculation of the yields on GNMA securities were brought to the Committee's attention. For a discussion of this issue see, "Figuring Rates on Ginnie Maes," New York Times, March 9, 1985, p. 30; "SEC Presses Mutual Funds Industry to Upgrade Information to Customers," Credit Markets, March 3, 1986, p. 9; "Don't Be Too Quick to Snub Ginnie Maes," Business Week, April 21, 1986, p. 77; "Reading Ginnie Mae Ads More But Enjoying Them Less?", Wall Street Journal, June 16, 1986, p. 25; "Ginnie Mae Investors Get Warning," Chicago Tribune, July 7, 1986, sec. 4, p. 9; "When Pluses Are Minuses," Forbes, July 14, 1986, p. 117; "Jolts for Those Who Invested in Ginnie Mae Mutual Funds," Washington Post Magazine, July 21, 1986, Washington Business Section, p. 51; and "The Saga of Ginnie Mae Takes a Sorry Turn," U.S. News and World Report, July 28, 1986, p. 42.

[40] The Committee does not consider advertisements or promotional materials to include research reports, statistical analyses or similar material provided only to selected customers or potential customers on limited basis. However, the Committee does not condone and will not tolerate the use of fraudulent, misleading, deceptive and false statements in general and statements that may be construed as advertisements of the yields available on GNMA securities or other mortgage related securities in the text of the materials referenced in this note.

Depository institutions

Government securities are also held by depository institutions in custody for their customers. The failure of these institutions to follow proper procedures in the custody of government securities can result in the affected bank customers being put in the position of unsecured creditors. The federal bank regulatory agencies have brought public and private enforcement actions to address these problems, and the Office of the Comptroller of the Currency has issued a Banking Circular covering the safeguarding of customer securities by national banks. Title III is intended to ensure that depository institutions adhere to proper procedures in the safekeeping and use of customer securities. Title III is not applicable to clearing agencies registered with the Commission pursuant to section 17A of the Exchange Act.

Title III authorizes the Secretary to promulgate standards for the safeguarding and use of government securities held by depository institutions as a fiduciary, custodian or as part of a similar arrangement for their customers. This title applies to depository institutions that are not government securities brokers or dealers but rather are effecting transactions in government obligations as an incidental activity to holding securities for their customers.

This grant of authority to the Secretary is not intended to subject depository institutions to inconsistent, overlapping, or duplicative regulation of fiduciary, custodian, and other safekeeping accounts. To avoid the dupliative regulation of these institutions, the Secretary is required to determine whether the rules and standards of each appropriate regulatory agency satisfy the objectives of Title III prior to adopting such regulations. If the Secretary determines that the appropriate agency's rules are adequate, the Secretary shall exempt any depository institution from the regulations promulgated pursuant to this title. Further, the Secretary shall consult with the regulatory agencies before promulgating these regulations. To satisfy the adequacy standard of this title, the existing rules of the federal regulatory agencies need not be the same as the Secretary would promulgate. Rather, the adequacy of existing regulations should be premised upon a determination by the Secretary that the existing regulations effectuate the purposes of this title.

Jurisdiction of the CFTC

The impact of legislation upon a controversy pertaining to a jurisdictional dispute regarding the regulatory status of off-exchange trading of government securities futures and options on those futures under a provision contained in Section 2(a)(1)(A) of the Commodity Exchange Act [41] was brought to the Committee's attention.[42] This controversy is totally unrelated to legislation's principal purposes and was not addressed at any of the hearings before the Securities Subcommittee.[43] Therefore, the Committee believes

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[41] This provision is commonly referred to as the "Treasury amendment."

[42] See, letter to Senator Alfonse M. D'Amato from CFTC Chairman Susan M. Phillips, July 17, 1986. Letter on file with the Senate Committee on Banking, Housing and Urban Affairs.

[43] In 1982, in endorsing the CFTC–SEC jurisdictional accord, the Committee recognized the role of the CFTC in regulating exchange trading of futures and options on futures contracts involving government securities. See S. Rep. 97–390, 97th Cong. 2d Sess., p. 6.

that this legislation is not the proper vehicle to resolve such a dispute.[44]

The Committee also does not intend to affect the jurisdiction of the Commodity Futures Trading Commission in any way. Therefore, the phrase "transactions in government securities" as used in the bill refers to transactions in government securities as the term government securities is described in subsection 42 of this legislation, rather than the trading in government securities futures and options on those futures. The Committee does not intend to affect the CFTC's exclusive regulation of futures and options on futures in government securities and did not intend to create any regulatory overlap with activities that are subject to CFTC jurisdiction. The Committee therefore adopted a specific provision, section 401(d), to confirm the Committee's intent not to affect the CFTC's jurisdiction.

Report to Congress

At present, a great deal of confusion exists with regard to the clearance and settlement of tranactions in the securities of government-sponsored corporations and of government agencies other than those issued by the Treasury. Stories abound regarding the inefficient methods that currently exist regarding the transfer and clearance of securities such as those guaranteed by GNMA.[45] Therefore, the Committee expects the Commission to undertake a study to evaluate present clearing, settlement and transfer mechanisms and the potential for future improvements of these mechanisms with regard to transactions in the securities of Government sponsored enterprises and of Government agencies other than those issued by the Treasury.

The Committee also understands that the Commission is preparing a report examining the internationalization of the securities markets. The Committee's interest in this issue was demonstrated during hearings the Committee conducted on February 26 and 27, 1986.[46] Rather then require the Commission to prepare an additional report regarding the internationalization of the securities markets, the Committee expects that the report currently being prepared by the Commission will be submitted to the Committee by October 31, 1987.

The report to the Committee shall include a study of the accelerating internationalization of the securities and currency markets and the implications of such internationalization with respect to the United States securities and currency markets and the regulation thereof, including but not limited to the regulation of the dis-

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[44] See, letter to Senator Alfonse M. D'Amato from Eric West, Chairman Primary Dealers Committee, Public Securities Association, August 12, 1986. Letter on file with the Senate Committee on Banking, Housing, and Urban Affairs.

[45] For recent discussions of this problem see, "The Day The Computers Went Down," Institutional Investor, March 1986, p. 203; "Mae Day," Forbes, March 24, 1986, p. 122; "Time For A Change," Credit Markets April 28, 1986, p. 8; "Book-Entry Blues, Forbes, May 5, 1986, p. 104; "Ginnie Mae Depository Problems Raises Concerns," Inside Mortgage Capital Markets, May 23, 1986, p. 4; "Crisis Atmosphere With Ginnie May Turning to Panic; Fears Mount that MBS Program Out of Control," Inside Mortgage Capital Markets, May 9, 1986, p. 3; "Ginnie May Near Decision on Issuing Debt in Book-Entry Form Agency Head Say," Credit Markets, May 19, 1986, p. 7.

[46] Hearings before the U.S. Senate Committee on Banking, Housing, and Urban Affairs. (99th Congress, 2d Session, February 26 and 27, 1986, S. Hrg. 99–661).

tribution and trading of securities and currency, clearing systems, and professionals who participate in such markets.

The report shall, at a minimum, discuss anticipated developments in the United States and elsewhere and possible federal legislative and regulatory action (both within and outside the Commission's jurisdiction) relating to:

(1) The effects on trading practices of technological developments, including automation and computerization and advances in communications technology;

(2) The possible design and development of a world-wide contemporaneous clearing and settlement system;

(3) The transition from national trading systems to global trading systems, particularly in relation to the role and appropriate regulation of U.S. participants;

(4) The trend toward increased investment of the assets of pension funds in the U.S. in non-U.S. securities;

(5) Surveillance of global securities trading and the need for cooperative international oversight systems, exchanges of information, and international enforcement cooperation;

(6) Procedures for listing, disclosure and distribution of securities, particularly in relation to multinational and international issues of securities;

(7) Institutional mechanisms for international cooperation in regulating securities and related transactions, particularly in relation to the appropriate role of U.S. regulatory bodies, self-regulatory organizations and private entities in the emerging global system; and

(8) The increasing securitization of financial instruments.

SECTION-BY-SECTION ANALYSIS

Section 1

This section provides that the title of the bill is the Government Securities Act of 1986.

Section 2

This section contains the congressional findings regarding the need for this legislation.

TITLE I

Section 101—Regulation of Government Securities Brokers and Government Securities Dealers. This section of the legislation adds a new section 15C to the Securities Exchange Act of 1934 [Exchange Act]. Section 15C provides for the registration of or notice filing by government securities brokers and government securities dealers. This section also invests the rulemaking authority with regard to the regulation of the government securities markets in the Secretary of the Treasury [Secretary]. The section references in the following analysis of section 101 are to the provisions of the new section 15C of the Exchange Act and not to the sections of this bill.

Section 15C(a)—Registration of government securities brokers and government securities dealers.

Paragraph (1)(A)—Registration of unregulated dealers. This provision makes it unlawful for a government securities broker or dealer (other than a registered broker or dealer, a primary dealer, or a financial institution) to make use of the mails or any means or instrumentality of interstate commerce to engage in government securities transactions unless that broker or dealer is registered in accordance with paragraph (2) of this section. Government securities brokers and government securities dealers registered under section 15C, unlike brokers and dealers registered under section 15, would not be members of the Securities Investor Protection Corporation [SIPC].

Paragraph (1)(B)—Notice filing requirements for registered brokers or dealers, primary dealers or financial institutions. This paragraph establishes different "registration" criteria for government securities brokers or dealers that currently are registered brokers or dealers, primary dealers or financial institutions. While the government securities activities of registered brokers or dealers, primary dealers or financial institutions are not consistently subject to direct regulation, these entities are subject to regulatory schemes that cover their other activities. Rather than subject these institutions to the registration requirements applicable to unregistered government securities brokers or dealers, this paragraph requires them to file a written notice with the appropriate regulatory agency for that entity. Similarly, they will be required to file a written notice when they cease to act as a government securities broker or government securities dealer. The appropriate regulatory agency will prescribe the form and information to be contained in the notices. Each appropriate regulatory agency shall make these notices available to the Securities and Exchange Commission [Commission]. Registered brokers or dealers, primary dealers or financial institutions cannot engage in government securities transactions until this notice is filed.

Paragraph (2)—Registration application. This paragraph requires a person to register as a government securities broker or government securities dealer by filing a registration application with the Commission containing such information and documents as the Commisson may, by rule, prescribe. The Commission would be required to grant registration or institute proceedings to deny registration within 45 days after receipt of the application by the Commission or within a longer period of time to which the applicant consents. The Commission would be required, by order after a hearing, to deny registration to any government securities broker and government securities dealer if it determined the applicant would be unable to comply with the provisions of the Exchange Act or the rules and regulations promulgated thereunder, including the rules promulgated by the Secretary, or, that if it were so registered, it would be subject to suspension or revocation of its registration under subsection (c).

Paragraph (3)—Prohibited conduct of government securities brokers and government securities dealers. This paragraph is the counterpart of existing section 15(b)(4) and 15B(a)(3) of the Exchange Act governing brokers, dealers, and municipal securities dealers and would make unlawful any act or practice or course of business prohibited by the Exchange Act (other than section 5 or

paragraph (1) of this subsection) by a registered government securities professional that would be prohibited if the mails or any means or instrumentality of interstate commerce were used in connection therewith irrespective of any use of such means.

Paragraph (4)—Exemptive authority. The Secretary is granted the authority to exempt a government securities broker or dealer or a class of government securities brokers or dealers from registration and rules under section 15C. An exemption is allowed only if the Secretary finds it is consistent with the public interest, the protection of investors and the purposes of this title.

Section 15C(b)—The authority of the Secretary. This subsection would delegate rulemaking authority to the Secretary for the government securities markets.

Paragraph (1)—The rulemaking authority. The Secretary is invested with the authority to promulgate rules to regulate the activities of government securities brokers and dealers that are designed to foster the purposes of the Exchange Act and, in particular, to prevent fraud. No government securities broker or dealer can engage or attempt to engage in a transaction in contravention of these rules. The scope of the Secretary's rulemaking authority is limited to rules that:

(1) Provide safeguards with respect to the financial responsibility and related practices of government securities brokers and government securities dealers including, but not limited to, capital adequacy standards, the acceptance of custody and use of customers' securities, the carrying and use of customers' deposits or credits balances, and the transfer and control of government securities in repurchase agreements and similar transactions;

(2) Require every government securities broker and government securities dealer to make and transmit reports to and furnish copies of records to the appropriate regulatory agency, and to file annually or more frequently a balance sheet and income statement certified by an independent public accountant, prepared on a calendar or fiscal year basis, and such other financial statements (which shall, as the Secretary specifies, be certified) and information concerning its financial condition with the appropriate regulatory agency; and

(3) Prescribe records to be made and kept by government securities brokers and government securities dealers and the periods for which such records shall be preserved.

Paragraph (2)—The scope of the Secretary's rulemaking authority with respect to classes of government securities brokers or dealers. This paragraph permits the Secretary to classify government securities brokers, dealers and associated persons and specify that any or all of such rules are not applicable to certain classes of government securities brokers, dealers and associated persons.

Paragraph (3)—The scope of exemption from the Secretary's rules for registered brokers or dealers, primary dealers or financial institutions. Prior to the adoption of the rules referred to above, the Secretary is given the authority to exempt those government securities brokers and dealers that must file a notice (those that do not have to register with the Commission) if the existing rules of

the appropriate regulatory agency for those entities adequately meet the purposes of the rules the Secretary must promulgate.

In the promulgation of the rules, the Secretary must consult with and consider the views of the Commission and the Board of Governors of the Federal Reserve System (Federal Reserve Board). The Secretary does not have to consult with the Commission or the Federal Reserve Board in the case of an emergency requiring expeditious and summary action provided the Secretary states the reason for this determination.

Paragraph (4)—Liability of government securities brokers or dealers. This paragraph makes it unlawful for any government securities broker or dealer to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any government security in contravention of any rule adopted pursuant to Section 15C.

Section 15C(c)—Enforcement and inspection by the Commission and the appropriate regulatory agencies.

Paragraph (1)—Commission's administrative power to sanction government securities brokers and government securities dealers. With respect to those government securities brokers or dealers that must register with the Commission, the Commission can censure, limit the activities of, suspend the registration or revoke the registration of those brokers and dealers. The Commission can also censure, suspend or bar a person associated with a government securities broker or dealer for violations of this Act. The Commission can take these actions after an opportunity for a hearing. Pending final determination of whether the registration of these brokers or dealers shall be revoked, the Commission may suspend registration, if after an opportunity for hearing, the Commission determines that the suspension is necessary, appropriate or in the public interest. Provisions are also included that permit the voluntary withdrawal from registration.

Paragraph (2)—The appropriate regulatory agencies' power to sanction government securities brokers and government securities dealers. The appropriate regulatory agencies for those government securities brokers and dealers not required to register with the Commission are invested with the authority to impose sanctions on the individuals and entities within the scope of their authority. The appropriate regulatory agencies for these government securities brokers and dealers are invested with the authority to enforce compliance by any government securities broker or dealer or associated persons for violations of this Act and the rules promulgated thereunder. The appropriate regulatory agency will file a notice with the Commission upon the imposition of a sanction on those brokers, dealers or associated persons within the scope of the appropriate regulatory agency's jurisdiction. Nothing in this provision affects the powers of the appropriate regulatory agency to proceed against government securities brokers or dealers under any other provision of law.

It is unlawful for a person who has been suspended or barred from association with a government securities broker or dealer to become associated with another government securities broker or dealer without the consent of the appropriate regulatory agency. It is also unlawful for a government securities broker or dealer to allow such a person to become associated with the entity if the

broker or dealer knew or, in the exercise of reasonable care, should have known of the suspension or bar.

Paragraph (3)—Commission and appropriate regulatory agency power to sanction persons seeking to become associated with a government securities broker or a government securities dealer. This paragraph makes it unlawful for any person, subject to an order entered by the Commission or an appropriate regulatory agency limiting his activities or functions, willfully to act or function beyond those limitations in connection with the business of any government securities professional, or for government securities brokers or dealers to permit a such person to be or to become an associated person or to act or function beyond those limitations without the consent of the Commission or the appropriate regulatory agency.

Section 15C(d)—Examinations. The records of all government securities brokers and dealers are subject to reasonable periodic, special or other examinations by the appropriate regulatory agency for that broker or dealer. Information received by any appropriate regulatory agency or the Secretary about a government securities broker or dealer or an associated person may be made available to the Secretary, the Commission, an appropriate regulatory agency or a self-regulatory organization.

Section 15C(e)—Membership of government securities brokers and government securities dealers in a registered national securities exchange or a registered securities association. Paragraph (1) of this section would require government securities brokers and dealers subject to registration under section 15C(a)(1)(A) to be members of the National Association of Securities Dealers or a registered national securities exchange.

Paragraph (2) permits the Commission, after consultation with the Secretary, to exempt conditionally or unconditionally, any government securities brokers or dealers subject to registration under section 15C(a)(1)(A) from the requirements of section 15C(e)(1).

Section 15C(f)—Protection of agency authority. Nothing in the bill is designed to limit the existing authority of the Commission, the Federal Reserve Board, Secretary, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, the Federal Savings and Loan Insurance Corporation, the Secretary of Housing and Urban Development or the Government National Mortgage Association [GNMA]. Thus, for example, the Comptroller of the Currency retains its authority over subsidiaries of national banks that are registered with the Commission as government securities brokers or dealers. Similarly, the Commission retains its antifraud authority over all persons (section 10(b), and all brokers and dealers (section 15(c)(1)) and its authority under section 21 of the Exchange Act to investigate all violations and suspected violations of that Act and the rules and regulations thereunder by any person. However, paragraph (2) limits the Commission's ability to enforce the provisions of section 15C to those government securities brokers, dealers or associated persons for which the Commission is the appropriate regulatory agency.

TITLE II

Section 201—Conforming definitions. This section contains amendments to current provisions of the Exchange Act necessary to further carry out the purposes of the bill. With the exception of the analysis of sections 202 through 208, the section references in the following analysis correspond to the Exchange Act.

Section 3(a)(34)—Definition of appropriate regulatory agency. When used with respect to a government securities broker or government securities dealer, or person associated with a government securities broker or government securities dealer:

(i) The Comptroller of the Currency, in the case of a national bank, a bank in the District of Columbia examined by the Comptroller of the Currency, or a Federal branch or Federal agency of a foreign bank (as such terms are defined in the International Banking Act of 1978);

(ii) The Board of Governors of the Federal Reserve System (Federal Reserve Board), in the case of a State member bank or the Federal Reserve System, a primary dealer (regardless of whether such primary dealer is a person of a type specified in any other clause of this subparagraph), a foreign bank, a State branch or a State agency of a foreign bank, or a commercial lending company owned or controlled by a foreign bank (as such terms are defined in the International Banking Act of 1978);

(iii) The Federal Deposit Insurance Corporation, in the case of a bank insured by the Federal Deposit Insurance Corporation (other than a member of the Federal Reserve System or a Federal savings bank);

(iv) The Federal Home Loan Bank Board, in the case of a Federal savings and loan association, Federal savings bank, or District of Columbia savings and loan association;

(v) The Federal Savings and Loan Insurance Corporation, in the case of an institution insured by the Federal Savings and Loan Insurance Corporation (other than a Federal savings and loan association, Federal savings bank, or District of Columbia savings and loan association); and

(vi) The Commission, in the case of all other Government securities brokers and Government securities dealers.

Section 3(a)(39)—Definition of statutory disqualification. This definition expands statutory disqualifications to include administrative sanctions imposed against government securities brokers and government securities dealers and associated persons and for all regulated entities and associated persons includes not only Commission sanctions but those of other appropriate regulatory agencies.

Section 3(a)(42)—Definition of government securities. The term "government securities" means—

(A) Securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States;

(B) Securities which are issued or guaranteed by corporations in which the United States has a direct or indirect interest and which are designated by the Secretary of the Treasury for ex-

emption as necessary or appropriate in the public interest or for the protection of investors;

(C) Securities issued or guaranteed as to principal or interest by any corporation the securities of which are designated, by statute specifically naming such corporation, to constitute exempt securities within the meaning of the laws administered by the Commission; or

(D) For purposes of section 15C, any put, call, straddle, option, or privilege on a security described in subparagraph (A), (B), or (C) other than a put, call, straddle, option, or privilege—

(i) That is traded on one or more national securities exchanges; or

(ii) For which quotations are disseminated through an automated quotation system operated by a registered securities association.

Under the definition contained in the legislation, securities issued or guaranteed by certain corporations affiliated with the Federal Government, which presently constitute exempt securities without designation by the Secretary, are "government securities" without action by the Secretary. These corporations include the Federal Home Loan Mortgage Corporation [FHLMC], the Federal National Mortgage Association [FNMA], the Student Loan Marketing Association [SLMA] and any other corporations having a statutory securities law exemption of the same type as these three corporations. In addition, the definition continues to permit designation of exempted securities by the Secretary. Finally, for purposes of section 15C, over-the-counter, nonstandardized options on government securities are also defined as government securities. Thus, persons who trade these securities are subject to registration and regulation as government securities brokers and government securities dealers. Although, as a statutory matter, this presents the possibility of dual regulation of such persons, currently Exchange Act rule 3a12–7 treats most of such securities as exempted securities. Given the changing nature of the options markets, the Commission will retain its full authority to regulate such options as nonexempted securities should it determine that it is necessary or appropriate to do so.

Section 3(a)(43)—Definition of government securities broker. A "government securities broker" is defined to mean a person regularly engaged in the business of effecting transactions in government securities for the account of others. The term does not include a corporation whose securities are designated by statute as exempt securities or are government securities pursuant to designation by the Secretary. The term does not include persons engaged in commodities future transactions specified in this section so long as that person's government securities activities are defined by Commission rule to be incidental to that person's futures-related business.

Section 3(a)(44)—Definition of government securities dealer. The term "government securities dealer" brings the activities of dealers and financial institutions with respect to government securities within the purview of the Exchange Act. This definition parallels

the definition of municipal securities dealer, contained in section 3(a)(30) of the Exchange Act.

"Government securities dealer" is defined to mean any person engaged in the business of buying and selling government securities for his own account through a broker or otherwise, including a financial institution if the financial institution is engaged in the business of buying and selling government securities for its own account other than a fiduciary capacity. Like the definition of government securities broker, the term does not include a corporation whose securities are designated by statute as exempt securities or are government securities pursuant to designation by the Secretary. The term does not include a person engaged in commodities futures transactions specified in this section so long as that person's government securities activities are defined by Commission rule to be incidental to that person's futures-related business.

Section 3(a)(45)—Definition of primary dealer. The term "primary dealer" means a government securities dealer that is monitored by, reports to, and is recognized as a primary dealer by the Federal Reserve Bank of New York.

Section 3(a)(46)—Definition of person associated with a government securities broker or a government securities dealer. The term "person associated with a government securities broker of government securities dealer" means any partner, officer, director, or branch manager of such government securities broker or government securities dealer (or any person occupying a similar status or performing similar functions), and any other employee of such government securities broker or government securities dealer who is engaged in the management, direction, supervision, or performance of any activities relating to government securities, and any person directly or indirectly controlling, controlled by, or under common control with such government securities broker or government securities dealer.

Section 3(a)(47)—Definition of financial institution. The term "financial institution" means (A) a bank (as such term is defined in paragraph (6) of this subsection), (B) a foreign bank, and (C) an insured institution (as such term is defined in section 401 of the National Housing Act).

Section 3(a)(48)—Definition of "registered broker or dealer." Under the bill, registered government securities brokers and registered government securities dealers are to be required to be members of national securities exchanges or registered securities associations. Accordingly, this definition provides that government securities brokers and dealers required to register pursuant to section 15C(a)(1) are deemed to be registered brokers or dealers solely for purposes of those provisions of the Exchange Act relating to membership in exchanges and associations.

Section 202—Enforcement and discipline. This section clarifies the Commission's authority to impose sanctions on a broker or dealer if the Commission finds that a broker or dealer or any person associated therewith has willfully made or caused to be made in any application for registration or in any report to be filed with an appropriate regulatory agency under the Exchange Act a false or misleading statement with respect to any material fact which is required to be stated therein. In addition, section 202(a) of

the bill makes section 15(b)(4)(B) applicable where the conviction in question arises out of the conduct of the business of a government securities broker or government securities dealer and make section 15(b)(4)(C) applicable where a broker or dealer is enjoined by a court from acting as a government securities broker or government securities dealer.

Section 202(b) ensures that, in the unusual case in which a registered broker or dealer is dealing only in government securities, the Commission's financial regulations will apply. Section 202(b) also provides that government securities brokers or dealers which are not registered brokers or dealers under the Exchange Act are subject to the rules concerning financial responsibility adopted by the Secretary under section 15C, not the financial responsibility requirements otherwise applicable under the Exchange Act.

Section 203—Rulemaking by registered securities associations. This section describes the relationship between government securities brokers and dealers and the registered securities associations. The registered securities associations will not have rulemaking authority over transactions by a government securities broker or government securities dealer in government securities or other instruments not regulated by the Exchange Act except that the registered securities associations are empowered to adopt rules that prohibit fraudulent, misleading, deceptive and false advertising. This provision is designed to deter false advertising related to GNMA yields. Further, since association membership is a key to examination and enforcement of Treasury rules, associations retain full authority to examine and discipline members, the authority to establish fees and the responsibility to fairly represent government securities brokers and dealers.

Section 204—Lost or stolen securities. This subsection is amended to make specific reference to government securities brokers and government securities dealers to clarify their obligation to report lost and stolen securities as required by Commission rules. The legislation authorizes the Secretary to forward information concerning lost, stolen, missing or counterfeit securities to the Commission or its designee. Nonbank government securities brokers and dealers are also subject to section 17(f)(2) concerning fingerprinting by virtue of their status as brokers and dealers.

Section 205—Burdens on competition. Amendments to this section extend to the Secretary the current requirement that in making rules and regulations the Commission must consider the impact any such rule would have on competition. The Secretary is prohibited from promulgating any rule imposing a burden on competition unless that burden is deemed by the Secretary to be necessary or appropriate in furtherance of the purposes of the Exchange Act. In adopting any rule imposing any burden on competition, the Secretary is required to give an explanation of its reasons for determining that the competitive burden is necessary or appropriate in furtherance of the purposes of the Exchange Act. Furthermore, the Secretary is required to make available for public inspection and copying all written statements filed with the Secretary and all communications between the Secretary and any interested persons concerning any rules made by the Secretary under this title or any proposed rule change by the Secretary except those that may be

withheld from the public in accordance with the provisions of the Freedom of Information Act.

Section 206—Amendment to the Investment Company Act of 1940. This section would amend section 9(a) of the Investment Company Act to add additional types of conduct to the existing list of activities that give rise to disqualification under the provision. The types of conduct that would be added are convictions or injunctions in connection with activities of municipal securities dealers, government securities brokers, government securities dealers and entities or persons required to register under the Commodity Exchange Act. Similarly, the section would add willful violations of the Commodity Exchange Act to the list of statutes, in section 9(b) of the Investment Company Act, the violation of which may give rise to administrative sanctions after notice and opportunity for hearing before the Commission.

Section 207—Amendment to the Investment Advisers Act of 1940. This section would amend section 203(e) of the Investment Advisers Act to add convictions and injunctions related to government securities brokers and government securities dealers activities to the list of permissible bases upon which the Commission may impose administrative sanctions on investment advisers and persons associated with investment advisers. In addition, the amendment would add, to the list of permissible bases for sanctioning investment advisers and their associated persons, activities of entities or persons required to register under the Commodity Exchange Act and violations of the Commodity Exchange Act.

Section 208—Definition of exempted securities. This section includes in the definition of exempted securities, as defined in section 3(a)(8) of the Securities Act of 1933, those securities which are guaranteed by an insurance or endowment policy having the highest investment grade rating.

TITLE III

Section 301—Standards for Depository Institutions holding government securities for customers' securities. Section 301(a) adds a new subsection 3121(b) to chapter 31 of title 31 of the United States Code, concerning the public debt. This provision requires the Secretary to promulgate standards for the safeguarding and use of obligations issued or guaranteed as to principal or interest by the United States. Such standards shall apply to depository institutions that hold such government securities as fiduciary, custodian, or otherwise for the account of a customer, but do not fall within the definition of a government securities broker or dealer. It is intended that these standards provide for the adequate segregation of government securities held for customers, including such securities purchased or sold subject to resale or repurchase.

The fiduciary activities of banks and other depository institutions are already subject to regulation by the respective appropriate regulatory agencies (including the National Credit Union Administration Board). Before adopting the regulations, the Secretary must determine whether the existing rules and standards of the appropriate regulatory agencies meet the purposes to be served by regulations to be promulgated pursuant to this subsection. Depository

institutions currently subject to rules and standards that are deemed adequate will be exempted from the regulations promulgated by the Secretary.

The regulations promulgated by the Secretary will be enforced by the appropriate regulatory agencies. Violation of the regulations may be the basis for issuance of a cease-and-desist order or other enforcement action. Nothing in this subsection is intended to affect the powers of the appropriate regulatory agency with regard to depository institutions and their affiliates and subsidiaries under any other provision of law.

Section 301(b) adds a new section 9110 to chapter 91 of title 31 of the United States Code, concerning government corporations. This provision parallels new subsection 3121(b), but applies to obligations of government-sponsored corporations whose securities are included in the bill's definition of government securities. Such corporations include, without limitation, the Federal National Mortgage Association [FNMA], the Federal Home Loan Mortgage Corporation [FHLMC], and the Student Loan Marketing Association [SLMA].

TITLE IV

Section 401—Transitional and savings provisions. Paragraph (a)—Effect on pending administrative proceedings. Nothing in this Act will affect any administrative proceeding pending on the effective date of the Act.

Paragraph (b)—Effect on pending judicial proceedings. Nothing in this law will affect suits commenced prior to the effective date of this Act. All pending proceedings, appeals taken and judgments rendered, will be done as if this Act had not been enacted.

Paragraph (c)—Discretion of the Federal Reserve Bank of New York. Nothing in this Act shall limit or impair the discretion or authority of the Federal Reserve Bank of New York to require reports or establish terms and conditions in connection with that Bank's relationship with any government securities broker or dealer, including primary dealers.

Paragraph (d)—Jurisdiction of the Commodities Futures Trading Commission. This Act does not affect the jurisdiction of the Commodities Futures Trading Commission with regard to the trading of commodities futures contracts and options on such contracts involving government securities.

TITLE V

Section 501—Report on transfers of Government Securities. Not later than 1 year after the date of enactment of S. 1416, the Commission, in consultation with the Treasury and the Federal Reserve Board, must transmit a report of Congress regarding the existing capabilities and future improvements for the clearance and settlement of transactions in government securities other than Treasury securities and the perfection of security interests in such securities.

TITLE VI

This title establishes the effective dates of the bill. The Secretary must issue, within 120 days of enactment, those regulations required to implement the Act and these regulations shall take effect as temporary regulations 180 days after the date of enactment. These regulations must be considered as final no later than 270 days after the date of enactment. No person may continue to act as a government securities broker or dealer after 270 days from the date of enactment unless the legislation's registration or notice requirements have been satisfied.

BUDGETARY IMPACT STATEMENT

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, September 2, 1986.

Hon. JAKE GARN,
Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has reviewed S. 1416, the Government Securities Act of 1986, as ordered reported by the Senate Committee on Banking, Housing, and Urban Affairs, August 13, 1986. We estimate that enactment of this bill would cost the Federal Government approximately $1.1 million annually beginning in 1987.

S. 1416 would make a number of changes in the regulation of brokers and dealers of government securities. It would require that certain government securities brokers and dealers register with the Securities and Exchange Commission [SEC], which would also have primary authority to oversee the market regulation of government securities dealers. Based on information from the SEC, we expect that implementation of this bill, including the reporting requirement to the Congress in 1987, would cost the SEC about $500,000 in 1987 and about $700,000 in each fiscal year thereafter.

The bill would require the Secretary of the Treasury to issue rules and regulations affecting capital adequacy standards and financial and reporting requirements. It would also provide the Secretary with authority to exempt certain brokers and dealers of government securities from registration, rulemaking, and recordkeeping requirements. Based on information from the Treasury Department, we expect that issuing rules would cost about $300,000 in 1987. Costs to the Treasury beyond 1987 are expected to be about $100,000 annually.

S. 1416 would authorize the Federal financial regulatory agencies to impose sanctions on those entities within their enforcement jurisdiction for violations of this act. These agencies include the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, and the Federal Savings and Loan Insurance Corporation. Although the number of broker-dealers affected by this legislation, as well as the rules and regulations that will affect its implementation are uncertain at this time, we expect that additional enforcement responsibility

could cost each agency several hundred thousand dollars annually. Generally, these costs would be offset by assessments on member institutions. The additional monitoring and examination costs to the Federal Reserve system are expected to be about $300,000 annually. These expenses would reduce the annual payment of surplus income that the Federal Reserve makes to the Federal Government, resulting in a reduction in Federal revenues.

If you wish further details on this estimate, we will be pleased to provide them.

With best wishes,

Sincerely,

RUDOLPH G. PENNER, *Director.*

REGULATORY IMPACT STATEMENT

Pursuant to Rule XXVI, paragraph 11 of the rules of the Senate, the Committee has evaluated the regulatory impact of the legislation and concluded that it would have a minimal impact on the regulatory burden of the Government. The legislation is principally designed to ensure that unregistered government securities brokers and dealers will no longer be able to operate outside of the existing federal regulatory structure. While the legislation invests limited rulemaking authority in the Secretary of the Treasury [Secretary], the legislation also invests the Securities and Exchange Commission [Commission] with the authority to determine the manner in which unregistered government securities brokers and dealers will be required to register and thus be brought within a Federal regulatory framework. The Commission presently serves in this capacity with regard to the registration of brokers and dealers that deal in non-exempted securities. Therefore, the legislation does not materially alter the regulatory role of the Securities and Exchange Commission, rather it expands the scope of the Commission's authority to include currently unregistered government securities brokers and dealers.

Similarly, the legislation has a minimal impact upon the regulatory burdens of the appropriate regulatory agencies defined in the bill. The legislation carefully avoids duplicative regulation of registered brokers and dealers, primary dealers and financial institutions, all of which are subject to some form of federal regulation. The legislation avoids unnecessarily increasing the regulatory burden of the appropriate regulatory agencies by allowing the Secretary to exempt government securities brokers and dealers from the rules the legislation empowers the Secretary to promulgate where such brokers and dealers are adequately regulated. Therefore, the regulatory burden upon the appropriate regulatory agencies will increase minimally, if at all.

There will be a minimal regulatory impact on newly regulated government securities brokers and dealers, since it is anticipated that much of the regulation will codify good business practice.

CHANGES IN EXISTING LAW

The Committee has determined that it is necessary, in order to expedite the business of the Senate, to dispense with the require-

ments of Rule XXVI, paragraph 2, of the rules of the Senate, with respect to this legislation.

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